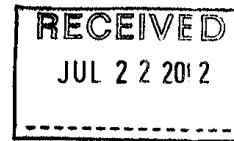




COMMISSIONER  
SMALL BUSINESS/Self-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

JUL 17 2002



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

*JG* Joseph G. Kehoe *Joe D. Kehoe*  
Commissioner, Small Business/Self-Employed Division

SUBJECT:

Draft Audit Report – The Internal Revenue Service Does  
Not Always Address Subchapter S Corporation Officer  
Compensation During Examinations (Audit # 200130027)

I reviewed the subject draft audit report. You set out to determine if we effectively identified Subchapter S Corporations (S Corps) that avoid FICA tax by compensating their officers with distributions or loans instead of a reasonable salary.

This has been a concern for quite some time. In 1998 our Kansas-Missouri and Ohio District Area Office Research and Analysis (DORA) staffs looked at the amount of underreported officer compensation and its underlying causes. They estimated that individuals may have underreported \$284 million in employment tax for tax year 1995. The major causes were:

- Intentional underreporting (\$106.8 million)
- Misinterpretation of reporting requirements (\$32.5 million)
- Taxpayer's lack of tax law knowledge (\$76.3 million)

The size of this tax gap warrants attention, but past enforcement resources targeting this issue through Information Gathering Projects did not significantly impact compliance. Compliance resources are in a period of decline and very limited. The tax gap for misinterpretation and lack of knowledge combined exceeds the impact of intentional underreporting, so pre-filing activity may be the best solution available.

Over the past several years we implemented the following actions to address this concern:

- Posted audit and classification tools discussing the Inadequate Officer Compensation issue on both the SB/SE and LMSB S Corp websites (An on-line S Corp Classification Checksheet is also available that separately lists Inadequate Officer Compensation (IOC) as an S Corp issue.)
- Featured articles on officer compensation and fringe benefits paid to shareholders in the January 2001 S Corp Newsletter

- Developed Examination guidelines to assist examiners in identifying IOC issues
- Added IOC as a topic on the agenda for Revenue Agent CPE in FY 2002
- Publicized on our Exam Specialization bulletin board software packages in SB/SE Compliance Area libraries that will help examiners establish reasonable compensation
- Began writing a Request For Information Services (RIS) for transcription of additional 1120S line items to include in the Midwest Automated Compliance System (MACS) database
- Began working with LMSB to develop an employment tax application for Examinations Operations Audit Databases (EOAD)
- Submitted a national Compliance Initiative Project (CIP) for approval to use MACS and other data sources to focus enforcement and educational resources on the IOC issue (A national CIP will allow consistent application of resources across the country based on levels of noncompliance. We can track cases identified for examination under this CIP using a project code.)

We agree a non-compliant segment of the S Corp population avoids FICA taxes by compensating officers with distributions and loans rather than salaries. Because of the decline in available enforcement resources, we believe we can best address this issue with a balanced approach that includes limited enforcement activity and expanded educational outreach. We will continue to enhance the technical guidance we offer classification and field personnel on this issue through CPE and web-based information. We will advertise the availability of software that the IRS owns to aid examiners in making reasonable compensation determinations. Transcribing additional return line items and measuring examination results can help focus our examination and educational resources on noncompliant taxpayers. We are requesting changes, but all changes must compete with other priorities for resources. Resources for additional transcription of return line items are particularly difficult to secure.

Because we cannot capture Form 1120S data electronically, we cannot identify the IOC issue without a time-consuming, costly physical review of returns broadly identified as potentially non-compliant. Consequently, TIGTA limited its review to a small, "judgmentally-selected" sample and drew conclusions on only 13 cases where the examiner made no comment on the issue. TIGTA's conclusion that the examiner could have missed up to \$648,065 in avoided employment tax is based on fact, but it applies only to those 13 cases and assumes we could successfully reclassify all distributions as compensation. The result does not apply to the entire S Corp population, and is not useful to a cost benefits analysis on the feasibility of implementing the recommendations.

Our comments on the specific recommendations are:

#### **RECOMMENDATION 1**

The Director, Compliance, SB/SE Division, should provide technical guidance and resources (such as software) to field personnel to aid in determining reasonable officer compensation.

#### **ASSESSMENT OF CAUSE**

Classifiers and examiners do not consistently identify and adequately address S Corps that may be avoiding employment tax by compensating officers with distributions and loans rather than salaries. The issue is difficult to address because determining reasonable compensation for officers' services is subjective and depends on facts and circumstances. Commercial software may be helpful for considering amounts paid by similar companies, but it is only a starting point because we must consider other factors including:

- Type and extent of services provided
- Characteristics of the business
- General economic conditions

#### **CORRECTIVE ACTION**

Publicize availability of software and continue to improve internal web-based resources.

#### **IMPLEMENTATION DATE**

December 31, 2002

#### **RESPONSIBLE OFFICIAL**

Director, SB/SE Compliance Policy, Reporting Enforcement

#### **CORRECTIVE MONITORING PLAN**

Director, Reporting Enforcement will inform the Deputy Director, Compliance Policy of any delay, change or problem with implementation.

#### **RECOMMENDATION 2**

The Director, Compliance, SB/SE Division, should submit a Request for Information Services (RIS) that would require the corporate distributions on the Schedule M-2 to be input to the IRS' computer system during returns processing, and therefore available to the MACS database. Classifiers should then use MACS when classifying Form 1120S returns.

#### **ASSESSMENT OF CAUSE**

Lack of transcription severely restricts our ability to identify and classify returns for many known compliance issues, including IOC. Ideally all line items would be available for electronic filtering and classification of returns, but transcription of line items from paper filed returns is an expensive manual process and resources budgeted for transcription are limited.

**CORRECTIVE ACTION**

Submit a RIS for transcription of additional Form 1120S line items including Schedule K, Line 20 Total Property Distributions and Schedule L, Line 7d Loans to Shareholders (ending balance). S Corp issue specialists believe Schedule K, Line 20 will provide more accurate information on corporate distributions to shareholders than TIGTA's recommendation to transcribe Schedule M-2. If Modernization, Information Technology and Security Services (MITS) implements the RIS, we will incorporate the additional data into the MACS database so it is available for electronic classification.

**IMPLEMENTATION DATE**

January 2004

**RESPONSIBLE OFFICIAL**

Director, SB/SE Compliance Policy, Workload Selection & Delivery

**CORRECTIVE MONITORING PLAN**

Director, Workload Selection & Delivery will inform the Deputy Director, Compliance Policy of any delay, change or problem with implementation.

**RECOMMENDATION 3**

The Director, Compliance, SB/SE Division, should submit a RIS to existing (and/or future) information systems (such as EOAD) to identify officer compensation-related adjustment assessments made to S Corporation employment tax accounts.

**ASSESSMENT OF CAUSE**

Although the examiner raises the IOC issue during an S Corp examination, the tax effect is on related employment tax returns. The Audit Information Management System (AIMS) Open Case, Closed Case and Summary Examination Time Transmission System (SETTS) Databases are the primary tools for measuring compliance results, but they do not measure results by issue. We developed the EOAD to monitor results by issue but it does not include employment tax data.

**CORRECTIVE ACTION**

LMSB and SB/SE are developing an EOAD application to capture employment tax examination results. We expect rollout early in FY 2003 after testing in summer 2002. We submitted a national Compliance Initiative Project (CIP) for approval to use MACS and other data sources to focus enforcement and educational resources on the IOC. As a national CIP, it will allow consistent application of resources across the country to address this issue and tracking of examination activity using a project code.

**IMPLEMENTATION DATE**

November 2002

**RESPONSIBLE OFFICIAL**

Director, SB/SE Compliance Policy, Workload Selection & Delivery

**CORRECTIVE MONITORING PLAN**

Director, Workload Selection & Delivery will inform the Deputy Director, Compliance Policy of any delay, change or problem with implementation.

**RECOMMENDATION 4**

The Director, TEC, SB/SE Division, should develop consistent materials for educating and informing taxpayers and representatives of their S Corporation officer compensation tax obligations. Such materials could include sending out pre-filing literature to taxpayers electing S Corporation status.

**ASSESSMENT OF CAUSE**

While TIGTA was gathering data for this report, TEC had no framework in place to address specific issues surrounding S Corps, primarily because TEC was a new organization just building its infrastructure.

**CORRECTIVE ACTION**

The Director, TEC has developed Centers of Excellence to address issues within specific areas of non-compliance. The TEC Director, Area 5, responsible for the Center of Excellence (COE) for Flow-Through Entities and Abusive Schemes, will coordinate with the Director, Pre-filing Compliance Activities in TEC Headquarters to explore the most efficient and effective way to reach appropriate audiences. This will include outreach to practitioners and other external partners. We will also coordinate with all internal stakeholders to explore updating and reissuing Publication 589, Tax Information on S Corporations, and updating instructions for Form 2553, S Corporation Election, to add clear direction on officer compensation.

**IMPLEMENTATION DATE**

January 2004

**RESPONSIBLE OFFICIAL**

Director, Taxpayer Education and Communication  
Director, Area 5, Taxpayer Education and Communication

**CORRECTIVE MONITORING PLAN**

The TEC Area 5 Director will follow the progress in identifying the most effective ways to reach the appropriate audiences and inform the Deputy Director, TEC of any delay, change or problem with implementation.

If you have any questions, please call me at (202) 622-0600, or call Joseph Brimacombe, Director Compliance Policy, SB/SE at (202) 283-2200.